DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0312
Indianan Corporate Income Tax
For Taxpayer's First Short Tax Period of 1997

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ISSUE

I. **Applicability of the Adjusted Gross Income Tax and Gross Income Tax** –Royalty Income from Licensing Taxpayer's Trademarks and Trade Names.

Authority: IC 6-2.1-2-2; IC 6-3-2-2(a); IC 6-3-1-1 et seq.; Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994); Ind. Dept. of State Revenue v. Convenient Industries, 299 N.E.2d 641 (Ind. Ct. App. 1973); Thomas v. Indiana Dep't of State Revenue, 675 N.E.2d 362 (Ind. Tax. Ct. 1997); 45 IAC 1-1-51; 45 IAC 3.1-1-55.

Taxpayer argues that the Department erred when it assessed taxpayer for Indiana corporate income taxes based upon money received from licensing trademarks, trade names, and similar types of intangible assets.

STATEMENT OF FACTS

Taxpayer is an out-state-company which is the holder of trademarks, trade names, and similar intangible assets which are used by taxpayer's parent company and other affiliates. Taxpayer asserts that it has no office, no tangible personal property, and no employees within the state.

During 2003, the Department of Revenue (Department) conducted an audit review of taxpayer's business records. The Department concluded that taxpayer was receiving income from licensing its intellectual property within the state and that taxpayer should have been filing Indiana corporate income tax returns. Accordingly, the Department assessed taxpayer for the unpaid income tax attributable to taxpayer's first short tax period of 1997.

Taxpayer disagreed with the audit report's conclusions on the ground that the intellectual property had not acquired an Indiana business situs. Taxpayer submitted a protest to that effect on July 30, 2003. An administrative hearing was conducted during which taxpayer further explained the basis for its protest. This letter of Findings results.

DISCUSSION

I. Applicability of the Adjusted Gross Income Tax and Gross Income Tax –Royalty Income from Licensing Taxpayer's Trademarks and Trade Names.

Taxpayer owns the rights to certain trade names, trademarks, and other protected identifying features (intellectual property) used to distinguish and market the parent company's fast food restaurants. During the tax period here at issue, taxpayer received royalty income from Indiana restaurants. Taxpayer maintains that the royalty income is not subject to Indiana's corporate income tax scheme because the intellectual property never acquired an Indiana business situs. Instead, taxpayer argues that its only business activity was related to the maintenance, administration, and protection of the intellectual property and that all of this business activity took place at taxpayer's out-of-state location.

Taxpayer does not own or operate fast food restaurants. Instead, taxpayer – by means of its parent corporation – enters into franchise agreements entitling local restaurateurs to operate a local fast food business and to identify that business with taxpayer's intellectual property. The local restaurateurs and taxpayer's parent company (franchisor) enter into a franchise agreement which defines the rights and responsibilities of both parties. Included within the agreement, is a provision granting the franchisee the right to make use of taxpayer's intellectual property.

The franchisor describes itself as the owner of a "system" of restaurant operations marked by "distinctive building designs, advertising signs, specially designed equipment, equipment layout plans, food presentations and formulae, certain business techniques, systems and procedure, and a [franchisor's] operations manual." The franchise agreement provides to the individual franchisee the right to the limited use of taxpayer's intellectual property. That intellectual property is described as consisting of "trademarks, trade names, service marks, logos, insignia, slogans, emblems, symbols, designs and other identifying characteristics . . . ." However, the franchisee is required to "use the trademarks only in a manner expressly approved by Company." The franchisee's rights are "non exclusive, and the Company, in its sole and absolute discretion, [retains] the right to grant other licenses in, to and under the trademarks in addition to those licenses already granted . . . ." The franchisor reserves for itself the right "to develop and license other names and marks on any such terms and conditions as the Company deems appropriate."

The parties' agreement limits the way in which the franchisee may employ the intellectual property. For example, "The franchisee [may] not use the Trademarks in connection with any statement or material which may . . . be in bad taste or inconsistent with the Company's public image . . . ." The franchisee is precluded from adopting or using a mark, name, or design which "includes or is similar to any of the Company's trademarks, service marks, trade names, logos, insignia, slogans, emblems, symbols, designs, or other identifying characteristics." The franchisee is precluded from making any "additions to, deletions from [or] changes in the Trademarks . . . ."

Upon termination or expiration of the parties' agreement, the franchisee is required to "immediately discontinue the use of the System and Trademarks." In addition, the former

franchisee is required to "remove the Trademarks from all buildings, signs, fixtures and furnishings, and alter and paint all buildings and other improvements . . . a design and color which is basically different from the Company's authorized building design and painting schedule." The former franchisee is required to "change the color of the building," alter the appearance of the building's exterior windows, and replace the building's distinctive "roof with one made of another good quality material and design."

If the former franchisee fails to remove the identifying marks and distinguishing features, the franchisor reserves for itself the "right to enter upon the Restaurant premises . . . and make or cause such removal, alterations and repainting . . . ."

Upon termination of the agreement, the former franchisee agrees to discontinue using the franchisor's marks and agrees to not thereafter employ any competing mark which might "tend to give the public the impression that the [former] franchisee is or was a licensee or franchisee of, or otherwise associated with, the Company."

It is apparent from the terms of the franchise agreement, that taxpayer zealously guards its intellectual property, is prepared to defend that property from unlicensed interlopers, and that it attaches substantial value to the property. In returns for the rights to make use of the intellectual property, the franchisee agrees to pay the taxpayer a royalty fee based upon a percentage of the franchisee's gross revenues.

The issue is whether the money taxpayer receives from licensing its intellectual property to Indiana franchisees is subject to the state's corporate income tax scheme.

A. Adjusted Gross Income Tax.

Indiana imposes an adjusted gross income tax on income derived from sources within the state. The adjusted gross income tax, IC 6-3-1-1 et seq., is an apportioned tax specifically designed to reach income derived from interstate transactions. Thomas v. Indiana Dep't of State Revenue, 675 N.E.2d 362, 367-68 (Ind. Tax. Ct. 1997); *See also* Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264, 266 n. 4 (Ind. 1994). The legislature has defined "adjusted gross income" as follows:

> (1) income from real or tangible property located in this state; (2) income from doing business in this state; (3) income from a trade or profession conducted in this state; (4) compensation for labor or services rendered within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. IC 6-3-2-2(a).

In order for Indiana to tax the income derived from an intangible, the intangible – such as taxpayer's intellectual property – must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 states that "[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a 'business situs' elsewhere. 'Business situs' is the

place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property." 45 IAC 3.1-1-55.

For purposes of Indiana's adjusted gross income tax, it is apparent that taxpayer's intellectual property has acquired a "business situs" within the state. Taxpayer derives income from Indiana franchisees which pay taxpayer for the right to make use of taxpayer's trademarks and trade names in order to sell fast food to Indiana customers at Indiana business locations. Taxpayer may be entirely correct in its assertion that activities associated with the initial development and ongoing administration of the intellectual property take place outside Indiana. However, issues concerning the administration, maintenance, and protection of the intellectual property are finally irrelevant to the tax question here at issue. What is relevant are the royalties taxpayer receives by placing that intellectual property within the state because it is these royalties which represent the "value" of this property. The value attached to the intellectual property does not derive from – however necessary – activities surrounding the administration of the intellectual property outside this state but results from taxpayer's ability to exploit the value of the property within the stream of Indiana commerce and to derive income from its ability to do so. The intellectual property – consisting of words, symbols, color-combinations, decorative elements, and the like – is, standing alone, of no value unless taxpayer takes steps to associate that property with the conduct of a specific business operation. Taxpayer is not paid royalties because it successfully administers the intellectual property at an out-of-state location; taxpayer receives income because it licenses Indiana franchisees to associate that intellectual property with the Indiana franchisees' fast food business.

The terms of the parties' franchise agreement clearly indicate that taxpayer has placed a substantial value on these particular properties. It is, therefore, quite proper that taxpayer take steps to protect the property when it licenses Indiana franchisees to make use of the property within the state. However, the assertion that the intellectual property has not acquired an Indiana business situs is simply without foundation in law or common sense. Indeed, taxpayer's trademarks and trade names have become a ubiquitous part of the Indiana landscape. Taxpayer, having taken calculated steps to "dip its net" into the stream of Indiana commerce and derive Indiana income directly attributable to exploiting its intellectual capital within the state, should not be surprised that the income is subject to Indiana income tax. As the regulation itself states, "'Business situs' is the place at which [the] intangible personal property is employed as capital . . . ." 45 IAC 3.1-1-55. The place at which "value attaches to the [intellectual] property" is within the state of Indiana. Id.

B. Gross Income Tax.

In addition to the adjusted gross income tax, Indiana imposes a tax known as the "gross income tax" on the "taxable gross income" of a taxpayer which is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2.

Under the regulation governing the gross income tax, "taxable gross income" includes income that is derived from "intangibles." 45 IAC 1-1-51. The term "intangibles" includes:

> notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps," final judgments, leases, royalties, certificates of sale, choses in action *and any and all other evidences of similar rights capable of being transferred, acquired or sold.* (*Emphasis added*). Id.

In order for Indiana to impose the gross income tax on income derived from taxpayer's intangibles, the Department must determine that the income is derived from a "business situs" within the state. Id. The regulation states that a taxpayer has established a "business situs" within the state "[i]f the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana . . . ." Id. Once the taxpayer has established a "business situs" within the state, "and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes." Id.

The income derived from the taxpayer's licensing of its intellectual property within the state, is income derived from a "business situs" within Indiana and is properly subject to the state's gross income tax scheme. The intellectual property is "localized" within the state because the intellectual is integrally related to the fast food restaurants which sell food items labeled, promoted, and marketed using taxpayer's proprietary trademarks and trade names. The income at issue is not derivative of taxpayer's out-of-state activity in developing, managing, and protecting the intellectual property; the value of this intellectual property lies in taxpayer's ability to license the property for use within Indiana, to maintain rigorous control over the use of the property by its franchisees, and to derive the economic benefits attributable to the intangible property's Indiana business situs.

Taxpayer points to court of appeals decision in Ind. Dept. of State Revenue v. Convenient Industries, 299 N.E.2d 641 (Ind. Ct. App. 1973) as supporting the proposition that franchise income, received by out-of-state franchisor/taxpayer, is not subject to the state's gross income tax. However, in Convenient Industries, the plaintiff taxpayer was receiving money because it performed services for its individual franchisees at plaintiff taxpayer's out-of-state location. For example, plaintiff taxpayer performed management and bookkeeping services for the Indiana franchisees. Id. at 643. The plaintiff taxpayer received cash register receipt information, statements for supplies and other documents in each franchisee's 'daily report.'" Id. Having received this information, plaintiff taxpayer "computed and issued checks for the payroll and other obligations of the franchisee, prepared [franchisee's] tax returns, and maintained profit and loss statements and balance sheets for each store." Id. Based upon the information received and analyzed at plaintiff taxpayer's out-of-state location, plaintiff taxpayer thereafter "utilized computer analysis to offer advice to each franchisee regarding ways in which an operation might be made more efficient." Id. The court found that the "bulk of the labor in performances of their contracts with franchisees occurred in Kentucky." Id. at 646. Therefore, the court found that the money plaintiff taxpayer received in the form of "service fee[s]" and "advertising fee[s]" was "not properly the subject of the Indiana Gross Income Tax." Id. at 646.

Taxpayer's circumstances are not analogous to those of plaintiff taxpayer in Convenient Industries. In Convenient Industries, plaintiff taxpayer was receiving money because it was

performing management and advertising services, on behalf of its Indiana franchisees, at plaintiff taxpayer's Kentucky location. The court found that the money was not subject to gross income tax because the services were not performed in Indiana. However, what is at issue in taxpayer's own protest is the income specifically derived from licensing intellectual property for use within the state. Certainly, there are particular activities associated with the development, management, and protection of taxpayer's intellectual which are conducted outside Indiana; however, the taxpayer's Indiana restaurant franchisees did not send royalty checks to taxpayer because taxpayer managed intellectual property outside the state. Taxpayer received royalty checks because it licensed Indiana businesses to attract Indiana customers to purchase food consumed in Indiana. Taxpayer received royalties based upon the franchisees' gross income received in Indiana. The amount of that gross income is directly attributable to taxpayer's success in marketing and labeling itself in distinctive manner readily identifiable by taxpayer's familiar trademarks and trade names. The franchisees' gross income is a measure of the franchisees' success; that success is attributable –in large part – because of the franchisees' identification with the trade names and trademarks; taxpayer's portion of the gross income – in the form of royalties – is subject to Indiana's gross income tax.

Because the intangible intellectual property has acquired a business situs within the state and because the income at issue is "connected with that business, either actually or constructively," the income is subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

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